SSA/Wealth Advisors

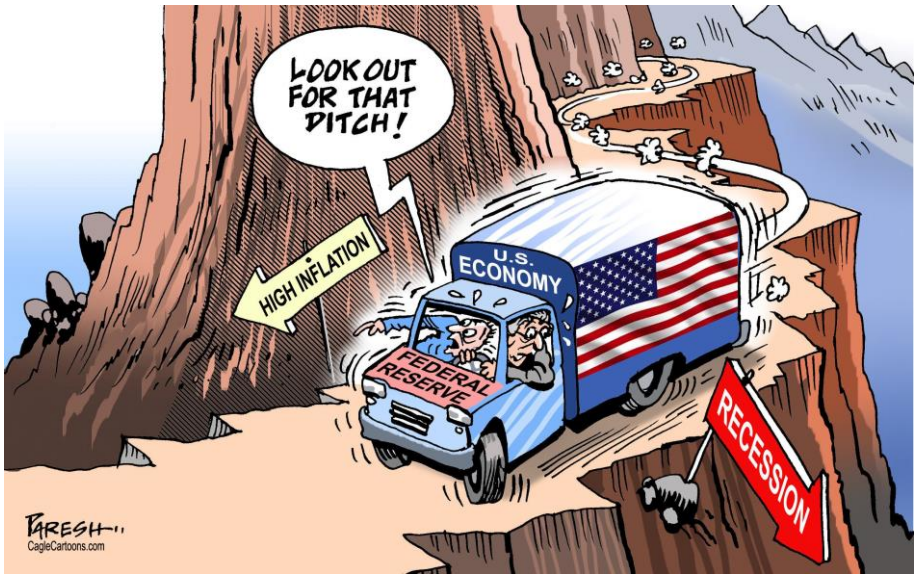
MARKET OUTLOOK

29 JUNE 2022

Ivo Kaufmann
Senior Portfolio Manager

Key points:

- **Global growth forecast revised down to 3% (from 4.4% early 2022)**
- **Equity exposure at underweight due to recession risk**
- **The Fed (Federal Reserve) rate is on the way up**
- **Keep bond duration short, but look for opportunities**
- **Gold long-term uptrend, but short-term neutral**



SSA Swiss Advisors AG
Uraniastrasse 34
CH – 8001 Zurich
Tel: +41 (0)44 206 60 40

www.ssaswissadvisors.com
info@ssas-wa.com

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Market Outlook

Since our last Market Outlook at the end of March, global risks have increased, as the Russia/Ukraine war continues and China's zero COVID policy has further boosted already high inflation.
Annual Consumer Price Index (CPI) readings reached their highest level in decades in both developed and emerging markets. The main issue with these latest rapid price increases is that they might become self-fulfilling, meaning that higher prices lead to higher wages and the expectation of higher prices in the future reinforces the inflationary narrative (a shift from an economic to a psychological phenomenon).
At this point, the formerly trendy and widespread belief that central bank money printing and fiscal spending is effectively unlimited (i.e., a 'free lunch') is going to be put on the back burner.
Central Banks have no other choice than to move into tightening mode and drain liquidity to stay credible, to restore price stability and to prevent long-term inflation expectations from de-anchoring.
Bottom line, the ultra-cheap money era is coming to an end.
While this adjustment process will take time and result in significantly slower growth, the risk of recession among the world's major economies has increased as well. Central Banks are walking a thin line between fighting inflation (hiking rates) and pushing the economy into recession. Although, we believe that central banks will do their utmost not to overshoot in this tightening cycle, allowing inflation to run to preserve growth, the general uptrend in rates seems to be a logical certainty.
Already in April the IMF (International Monetary Fund) cut its global growth forecast for 2022 to 3.6% because of Russia's invasion of Ukraine (this is down 0.8% since the IMF's January projections).
Since then, the economic picture has clearly deteriorated further, and the IMF is expected to again cut its forecast for global economic growth with its next update in mid-July. **Early in June, the World Bank already reduced its global growth forecast to 2.9% for 2022. Moreover, the OECD (Organization for Economic Co-operation and Development) cut its forecast as well to 3% at the same time.**
While the global composite PMI[1)] stayed still at 51.5 in May (indicating expansion), the number is well below its long-term average of 53.4. With growth obviously weakening, the risk is increasing that any extreme monetary tightening and/or additional supply shocks is going to put the economy in negative territory.

Equities

In the recent past, geopolitical crises - like the outbreak of war in Ukraine – have initially led to negative but short-lived market shocks, followed by fast relief rallies on perceived positive developments leading to buying opportunities for investors. Famous for this is the more than 200 years old quote from the British banker Nathan M. Rothschild: "buy on the sound of cannons; sell on the sound of trumpets."
This time, however, the situation is more complicated. Inflationary pressures - which have been initially caused by COVID-related factors – have been intensified by the Russia/Ukraine war.
As a result, central banks are now having to respond to these pressures at the most aggressive pace (increasing interest rates) since before the Global Financial Crisis. This will lead to slower global growth and equity markets are currently pricing in a new "reality".
As we know from the past, this is no simple process. First, expectations for future company earnings/cash flows must be revised down. Except for growth related sectors, we have not seen too many downward revisions of company earning lately. So, the probability that earnings expectations are too high – in the light of weakening growth – is currently very high. There might be more downside pressure coming from this side.

Second, the discount factor for those company earnings/cash flows must be estimated. At which interest rate level will central banks have done their job? Regarding this factor, we are quite confident that the market has already priced in most of the tightening cycle.

Therefore, in the search for entry points, investors will have to look at when valuations start to be consistent or even offer a positive attractive gap versus what the estimated equilibrium should be in the new "reality". At which point will the repricing in equities be over? Of course, we cannot know with certainty, but technical indicators can help us to see the bigger picture more clearly.

From a technical point of view, the recent decline has met the persistent selling criteria for a waterfall (persistent selling pressure over several weeks together with a surge in volume).

Also, the drop of over 20% in the S&P500 index since the start of the year (this year's low was so far on June 16th with – 23.5%) meets the criteria of a bear market. "The million-dollar question" is whether this is just a cyclical bear market within the longer-term uptrend of the market or if this is a more severe downtrend triggered by an upcoming recession and how severe this recession will turn out.

Ned Davis Research analyzed all bear markets since 1900 for the DJIA (Dow Jones Industrial Average Index) and found out that on average, cyclical bear markets that have overlapped with recessions have lasted longer and have declined 34.6% on average over 15.3 months versus a 24.9% drop over 9.1 months for non-recession bears.

Therefore, if history is any guide, the current decline (-18% for the DJIA at this year's low on June 17th) is approaching the median for non-recession bears. If, however, the economy will fall into recession, history suggests the bear market could last into 2023 and the percent decline could nearly double.

As the equity market is normally about 6 months ahead of the real economic data, we cannot know where this journey is taking us. Nevertheless, unless we see a bottoming process in the market, **we must assume that there is more downside risk out there.** A buying opportunity will only be at hand, once we see better than expected economic data and once many technical indicators turn positive again (like for example: less volume on down days, fewer stocks making new lows and others).

In conclusion, we believe it's too early to go for a more aggressive asset allocation, as visibility is still too low. Although, we do not expect the major economies to fall into recession, the risk is high, and the volatility will remain high as well. Therefore, we prefer to stay cautious and keep our equity exposure at underweight.

Chart: S&P500 (July-2021 to June-2022) with 50- & 200-day moving averages / source: marketmonitor.refinitiv

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Fixed Income

Since the 1960s there have only been two other times when core Personal Consumption Expenditures (PCE) inflation was as high as it is today in the U.S. The first was in 1974. Back then, the Fed downplayed the monetary factors that contributed to price rises and kept its policy rate relatively low. Consequently, it fell behind the curve, causing volatility in the real economy, higher inflation and multiple recessions.

In 1983, it did not wish to repeat its mistake and kept rates high in the face of declining inflation, eventually leading to the 1990-91 recession. Today it looks like we are closer to a 1974-style scenario, characterized by high, persistent, and self-perpetuating inflation, a low real policy rate and nominal rates trending upwards with no way to stabilize the volatility in the real economy. **Being aware of those circumstances, the Federal Open Market Committee (FOMC) – on June 15th - delivered a strong message by raising the fed funds target range by 0.75% to the range of 1.50% - 1.75%, the biggest hike since 1994.** This came on the heels of a reacceleration in CPI inflation to 8.6% y/y, a new high since 1981.

This kind of policy normalization entails a **high recessionary risk**. The Fed (and other central banks globally) must decide between killing inflation at the risk of triggering a recession now, or buying more time for nominal growth to increase, with a hefty price to pay later. Expectations in the markets are currently being built as to whether a soft landing is possible, and a recession can be avoided, as the risk of central bank policy mistakes is very high.

The Fed revealed at the FOMC that it sees the target rate in the range of 3.25% to 3.5% at year end. This is a range, the market could probably live with and as bond yields have already moved upwards a lot since the beginning of the year, it looks like most of the repricing in bonds might have taken place already. This means that medium-term bonds look much more attractive than a few months ago. **Nevertheless, investors should resist the temptation to add too much risk on the bond side as the great repricing of assets might continue for a while. We see more flexibility in duration management and are tactically looking at adding some medium-term bonds to our allocation. However, our overall bond duration remains in general very short during this period of turbulence.**

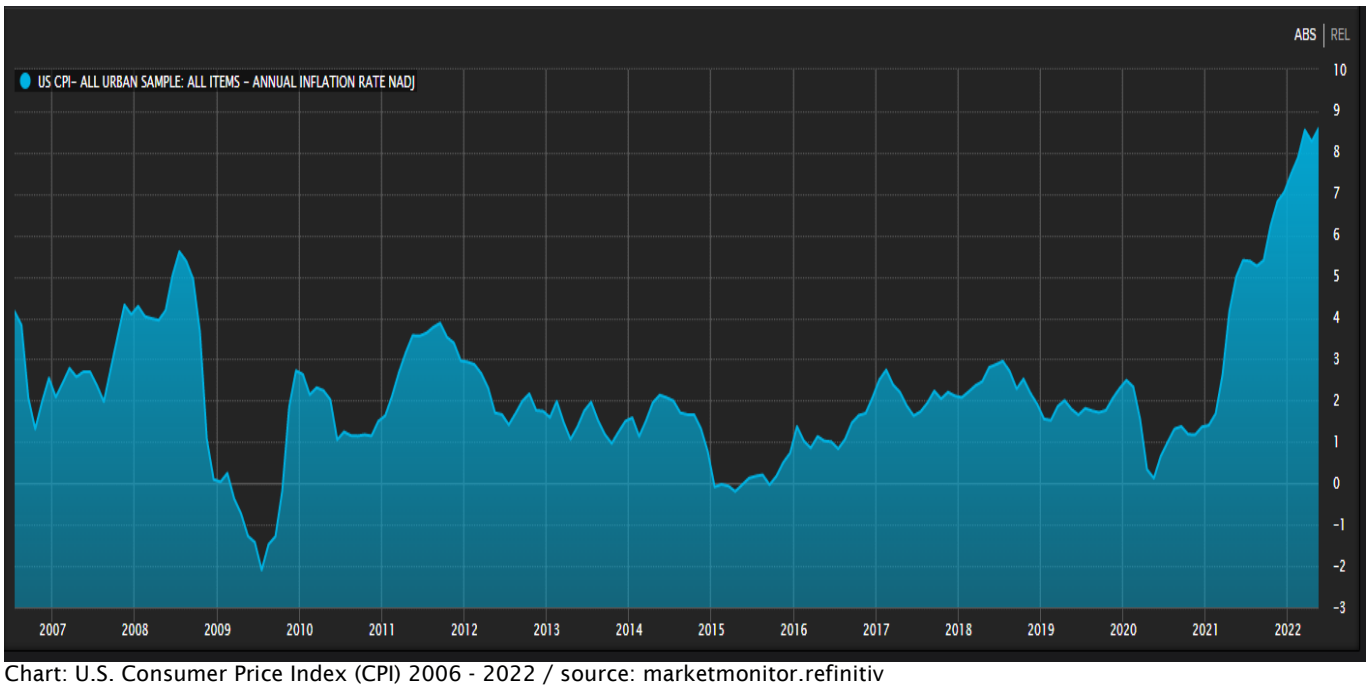


Chart: U.S. Consumer Price Index (CPI) 2006 - 2022 / source: marketmonitor.refinitiv

Forex/Gold

Both the USD and gold have been influenced by a development with an inverse impact – the trend and expectations for real interest rates. As the USD and gold tend to inversely correlate, one's recent success has been the other's failure. The USD has been supported by yields turning up in the U.S., while gold became relatively less appealing as it pays no interest rate. Therefore, while the USD has this year gained versus major currencies like the CHF, GBP or EUR, gold is trading sideways. This is at first sight a bit disappointing, because during times of high inflation, you would expect gold to gain and outperform in absolute terms versus other assets. However, we shouldn't look at this with too short-term of an optic. Gold remains in its long-term uptrend and once the Fed tightening cycle is over, gold will have more upside potential again. Until then, we remain neutral on both, gold and the USD.

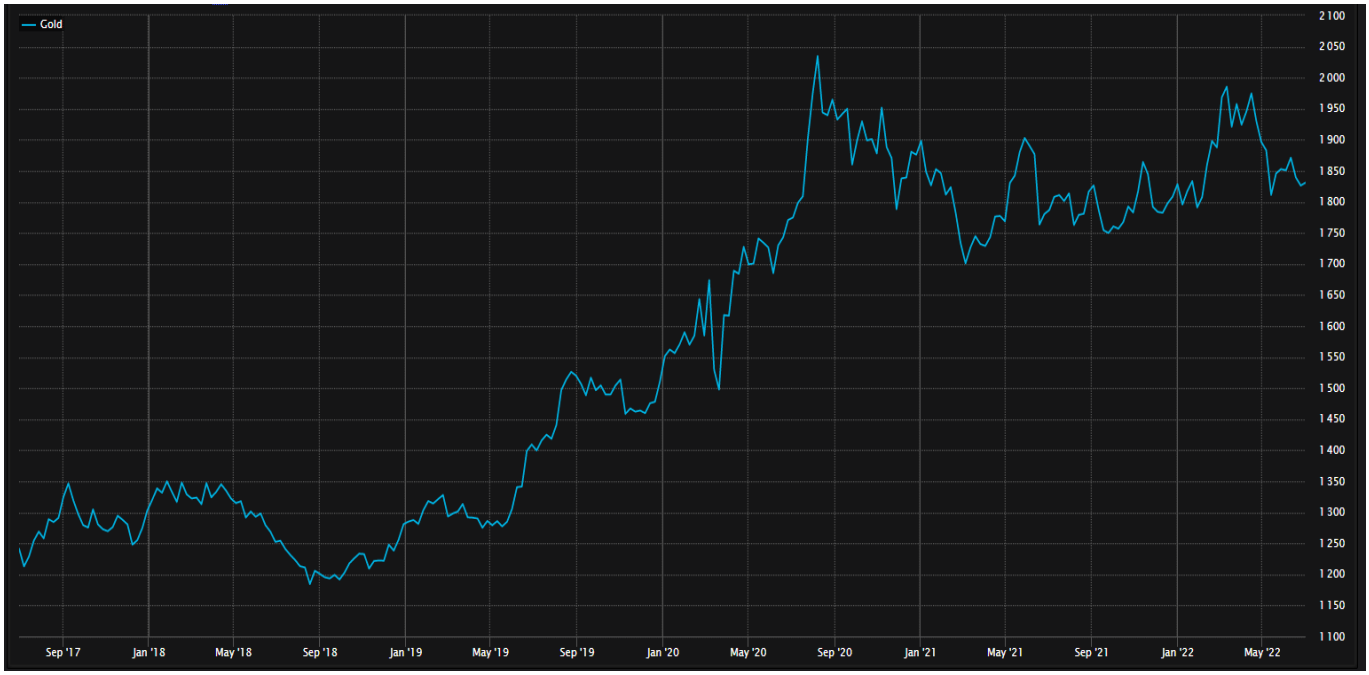


Chart: Gold USD/oz (July-2017 to June-2022) / source: marketmonitor.refinitiv

Please do not hesitate to contact us if you have further questions.
Best Regards
Ivo

1) The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It is a diffusion index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

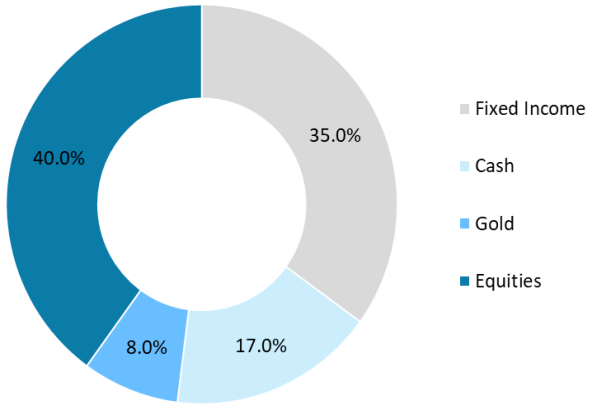
Source: Ned Davis Research, Financial Times, Amundi, IMF, World bank, OECD

Asset Allocation

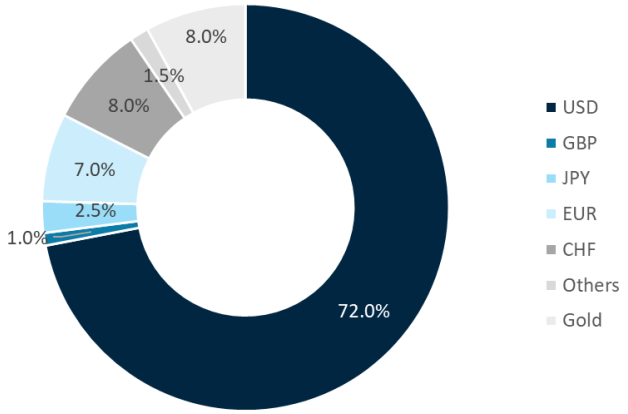
Given the factors described, we keep our equity allocation at underweight. (USD and CHF Balanced details below).

Current Allocation USD Balanced

Asset Allocation

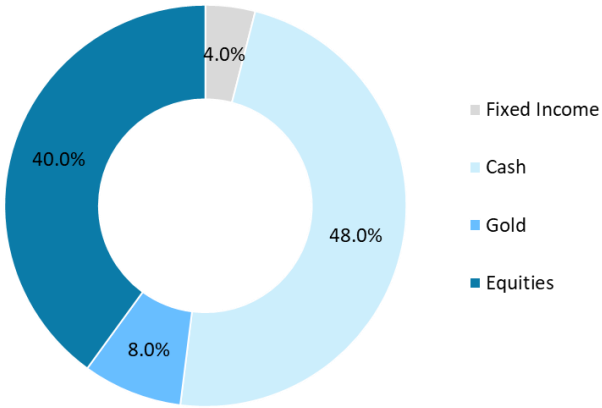


Currency Allocation



Current Allocation CHF Balanced

Asset Allocation



Currency Allocation